INTERNAL REVENUE SERVICE
NATIONAL OFFICE TECHNICAL ADVICE MEMORANDUM

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CASE MIS No.: TAM-112758-02/CC:PSI:B3

District Director
LMSB

Taxpayer's Name:
Taxpayer's Address:

Taxpayer's Identification No:
Years Involved:
Date of Conference:

LEGEND:

P =

Year 1 =

Year 2 =

a =

FACTS:

Through the end of Year 1, P was the common parent of an affiliated group of corporations ("the P group") that filed a federal income tax return on a calendar year basis. The P group deferred the gross profit on intercompany sales of inventory until such merchandise was disposed of outside the group. All of the intercompany transactions at issue in this technical advice request occurred in a tax year beginning after July 12, 1995. The taxpayer followed an internally developed formula, used on a consistent basis, to calculate the amount of deferral each year. For Year 1, the deferred net gross profit was $a.

On the first day of Year 2, P elected to be treated as an S corporation. P simultaneously elected to treat all of its subsidiaries as qualified subchapter S subsidiaries ("QSubs"), effective the same day as its S election.

ISSUES:

1. Whether the deferred gains on the sale of inventory between members of the P group must be included in the P group's income when P makes an S election for itself and QSub elections for its subsidiaries.

2. If the S election and QSub elections cause the deferred gains to be included in the P group's income, on what date are the gains triggered, and are the gains treated as built-in gain for purposes of § 1374?

CONCLUSIONS:

1. The deferred gains on the sale of inventory between members of the P group are included in the P group's income when P makes an S election for itself and QSub elections for its subsidiaries.

2. The deferred gains are included in the P group's income at the end of Year 1. The gains are not treated as built-in gain for purposes of § 1374.

DISCUSSION:

Section 1361(b)(3) provides that a QSub is not treated as a separate corporation from its S corporation parent, and that all its assets, liabilities, and items of income, deduction, and credit are treated as such items of its S parent. Section 1.1361-4(a) of the Income Tax Regulations further provides that a QSub election is treated as a deemed liquidation of the subsidiary into its S parent. The regulations generally treat this deemed liquidation as occurring at the close of the day before the QSub election is effective.

Section 1361-4(b) provides that if a C corporation elects to be treated as an S corporation and makes a QSub election (effective the same date as the S election) with respect to a subsidiary, the liquidation occurs immediately before the S election becomes effective, while the S electing parent is still a C corporation.

The intercompany transactions ("ITs") involved in this case are subject to the intercompany transaction regulations under § 1.1502-13 that are effective for transactions occurring in years beginning on or after July 12, 1995. Under these regulations, gains and losses from ITs generally must be included in income under the "acceleration rule" of § 1.1502-13(d). The acceleration rule causes deferred items to be restored whenever the selling or buying member ceases to be a member of the group. See §1.1502-13(d)(1)(i)(A). However, if the selling member or buying member ceases to be a member of a group because it transfers assets to another member of the group

in a transaction described in § 381(a), § 1.1502-13(j)(2) provides for continued deferral of intercompany items by treating the transferee member as a successor to the transferor member's items.

Under §1.1502-13(j)(2), the successor takes into account the transferor member's intercompany items in a manner consistent with the purposes of § 1.1502-13. Section 1.1502-13(j)(6) provides that if a consolidated group terminates because its common parent becomes the only remaining group member, the common parent succeeds to the treatment of the terminating group for purposes of § 1.1502-13, so long as the parent neither (i) becomes a member of an affiliated group filing separate returns, nor (ii) becomes a corporation described (as a non-includible corporation) in § 1504(b). S corporations are described in § 1504(b) as non-includible corporations. See § 1504(b)(8).

Section 1374(a) imposes a corporate level tax on the net recognized built-in gain of an S corporation that was formerly a C corporation during a 10-year recognition period beginning on the date it converted from C to S status ("built-in gain tax").

In this case, the QSub elections for P's subsidiaries are effective the same day as P's S election. The QSub elections are treated as deemed liquidations under § 332 of the subsidiaries into P, effective at the close of business on the day before the elections, which was the last day of Year 1. As a result of the deemed liquidations, at the close of the last day of Year 1, P is the only remaining member of the P group, and momentarily succeeds to the group's deferred items under the principles of §§ 1.1502-13(j)(2) and 1.1502-13(j)(6). Immediately thereafter, when P's S election becomes effective, the P group's items are no longer subject to deferral under § 1.1502-13(j)(6) and must be taken into account at that time. P therefore must include the gains on its Year 1 tax return.

Section 1374 does not apply to the recognized gain, because the income already would have been taken into account on the P group's final consolidated return. We also note that because the intercompany sales that resulted in deferred gain increased the basis of the sold properties, the taxpayer will not have built-in gain subject to § 1374 with respect to those properties, except to the extent that the value of such properties may have appreciated since the time of the intercompany sale.

A copy of this technical advice memorandum is to be given to the taxpayer. Section 6110(k)(3) provides that it may not be used or cited as precedent.